



Munich Personal RePEc Archive

# **FDI in the New European Neighbours of Southern Europe: a quest of institutions-based attractiveness**

Nathalie Fabry and Sylvain Zeghni

Université de Marne-la-Vallée

April 2006

Online at <http://mpra.ub.uni-muenchen.de/1109/>

MPRA Paper No. 1109, posted 10. December 2006

# **FDI in the New European Neighbours of Southern Europe: a quest of institutions-based attractiveness**

**Nathalie FABRY<sup>1</sup> and Sylvain ZEGHNI<sup>2</sup>**

## **Introduction**

At the beginning of the transition process, initial conditions were critical and the need of deep and sustained reforms was important to recover a dynamic growth path (World Bank, 2002). If some Central and Eastern European Countries (CEECs) integrated recently the EU after more than 10 years of transition<sup>3</sup>, South Eastern European Countries (SEECs) have to continue to set up deep reforms and institution building to reach this aim<sup>4</sup>. They are latecomers for four main reasons. First, the collapse of communism created windows of opportunities for ethnical and religious communities. The splitting of the Yugoslav Republic into Bosnia & Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, and Serbia & Montenegro was a

---

<sup>1</sup> Associate Professor (Ph.D.), University of Marne-la-Vallée (France) - *E-mail* : [nathalie.fabry@univ-mlv.fr](mailto:nathalie.fabry@univ-mlv.fr)

<sup>2</sup> Associate Professor (Ph.D.), University of Marne-la-Vallée (France) - *E-mail* : [sylvain.zeghni@univ-mlv.fr](mailto:sylvain.zeghni@univ-mlv.fr)

<sup>3</sup> In May 2004 Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia became EU members.

<sup>4</sup> The SEECs countries are: Albania, Bosnia & Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania, and Serbia & Montenegro (Broadman & al., 2004). McGee (2003) adopts a more open definition of SEECs and adds Greece, Slovenia, and Turkey. We exclude Greece and Slovenia because they are still EU members and Turkey because it is not a former communist country. Among SEECs, Bulgaria, Croatia and Romania and the FYR of Macedonia (since December 2005) are still candidate countries.

consequence of internal conflicts and civil wars (Broadman and al., 2004). These 'new' but heterogeneous micro countries may not be naturally attractive for FDI. They lack of intra-regional integration and have small market sizes. Second, the SEECS have to set up major reforms, to help institutions to support the market economy and to facilitate the development of the private sphere on an internationally competitive base. The task is difficult because of the high rate of poverty and the war disasters that damaged the political stability, the infrastructure reliabilities and contributed to the disintegration of the industrial structures. Moreover, in these countries, the informal institutions linked to the historical and ethnical roots, combined with the communist legacy, play a major role in defining specific social rules and habits. Third, for the most advanced of them, SEECS have to fulfil the three main Copenhagen criteria before accession. The *political criterion* focuses on the stability of institutions, the level of democracy, the rule of law, the human rights and the respect for and protection of minorities. The *economic criterion* deals with the existence of an efficient market economy as well as the capacity to cope with competitive pressure and market forces within the European Union. At last, the *Acquis Communautaire criterion* reflects the ability to take on the obligations of membership including adherence to the aims of the Political, Economic and Monetary Union. Finally, SEECS are at the periphery of the EU in a geographical point of view but also in an economic and social one.

The post-communist countries have also to deal with the challenge of globalization. All countries, whatever their development level and historical background, have to host inward-FDI to stay competitive. In the specific case of transitional countries, FDI may help to retool industry, to achieve modernization, industrial upgrading and improve productivity by importing foreign technologies, diffusing knowledge and western best practices. They

also may help to develop international trade (Fabry & Zeghni 2003a; Paas, 2003; Zakharov & Kušić 2003).

The war in Former Yugoslavia had a serious negative impact on the local economic landscape and on the foreign investors' perception of risks (East West Institute, 2000). Among countries not devastated by ethnical conflicts, the level of the corruption, the lack of entrepreneurship mood and capabilities, the weaknesses of the industrial structures, and the uncertain perspective of the EU accession deter inward-FDI. The lack of market-oriented institutions and the presence of deeply rooted informal institutions such as black markets seem us to be of a major concern. As shown by World Bank (2002) and Broadman and al. (2004), the SEECS decided to protect former state owned enterprises by giving subsidies granted through the budget and local banks. **Local entrepreneurship and foreign investors are disappointed by the weak public and corporate governance and the asset-stripping (Dallago, 2005).** High tax rates, abuse in licensing and registration procedures, weak legal and judicial system discourage inward-FDI (OECD, 2001). Corruption starts to become a serious obstacle to the growth of new enterprises (Gray, Hellman & Ryterman, 2004)<sup>5</sup>. The SEECS are not among the countries that receive the more inward-FDI at the present time and they receive less inward-FDI than the CEECS on the

---

<sup>5</sup> Nevertheless, in the Stability Pact for South-eastern Europe, the Investment Compact is a very interesting initiative. The SEECS have adopted a joined procedure to encourage FDI. This initiative tends to permit a quasi-uniform procedure to host FDI and to improve transparency. With the Investment Compact, the SEECS works together for unifying FDI registration and approval procedures with those for domestic firms, allowing acquisition of real estate by foreign investors for FDI purposes, minimizing FDI-related requirements on statistical reporting, work and residence permits, eliminating discrimination in access to government procurement contracts and removing obstacles to FDI in financial and professional services. (OECD, 2005)

period 1998 – 2003<sup>6</sup>. Nevertheless, several major features can be put in evidence: the political instability, the weak infrastructures and a lack of perspective to become EU Member (Hunya, 2002; Botrić & Škuflić, 2005).

As shortly described, the actual institutional context is a barrier to attractiveness and development **while** the restoration of sustained growth and poverty reduction are key priority for SEECS<sup>7</sup>. The main question we set in this paper is whether or not the weak inward-FDI are linked to non reliable institutions and to a non EU membership. The aim of the paper is to understand the role of institutions in shaping a strong localization advantage for FDI. The quest of reliable and safe institutions has recently emerged in the economic literature, first as a catalyst for growth (Bardhan, 2005; Gwartney. Holcombe & Lawson, 2004; Rodrik & Subramanian, 2003; Edison, 2003) and more recently as an inward-FDI attractor mainly in transition economies (Pournarakis & Varsakelis, 2004; Bevan, Estrin & Meyer, 2004). Contrary to the New Institutional School, we argue that institutions are not pre-conditions to host FDI. In the transition context, institutions are the result of an interaction between host country and foreign investors. That is what we call institutions-based attractiveness.

---

<sup>6</sup> The FDI inflows to SEECS have increased from 408 millions \$ in 1993 to 6.7 billions in 2003. In 1993, FDI Inflows to SEECS represented 8% of the total FDI in the CEECs, in 2002 it represented 20% and in 2003 60%. This trend is explained by the fact that in transition countries, FDI are strongly related to privatizations. As the UNCTAD (2005) shows, the decline of FDI in the CEECs is strongly linked to the decline of privatizations. The Greenfield FDI in the CEECs are not strong enough to compensate the FDI-led privatization. On the Contrary, in the SEECS after a long period of *statu quo*, a large movement of privatization is starting that encourages FDI.

<sup>7</sup> “By 2001, the region had reached only 74 percent of its pre-transition (1989) level of economic activity. In comparison, the five most developed Central European transition economies (the Czech Republic, Hungary, Poland, the Slovak Republic, and Slovenia) had increased their combined output to 115 percent of 1989 levels.” Page XXI (Broadman and al. 2004).

This paper is structured as follows: in section I we develop a theoretical framework to understand the relationship between Transition, Institutions and inward-FDI and present a set of hypothesis. In section II we develop our empirical analysis and methodology. Finally, we conclude on the relevance of our results. We will focus on the formal institutions mainly market supporting ones and will not deal with informal institutions which are in these countries of a very high importance. Our choice is due to the difficulty to quantify the influence of informal institutions.

## **I. A theoretical framework of institutions as FDI determinants**

The question we address in this section is: What does theory tell us about FDI determinants in general and in what extend do institutions matter to attract FDI particularly in transitional countries?

### **1. FDI determinants: an emphasis on the localization advantage**

The theory of FDI determinants may be resumed by Dunning's OLI framework (1993). To invest abroad, a firm needs to gather simultaneously three advantages: an *Ownership advantage* that may be seen as one or more intangible assets of the firm over its competitors; a *Localization advantage* which is located in the host country and attracts the foreign investors; and an *Internalisation advantage* that gives the firm an opportunity to avoid pure market transactions. Among these three advantages, the *Localization advantage* gains increasingly in importance since the global era. This advantage is first based on *natural assets* and may reflect three major MNE's

strategies: *supply-oriented or resources seeking, demand-oriented or market-seeking, efficiency-seeking or global.*

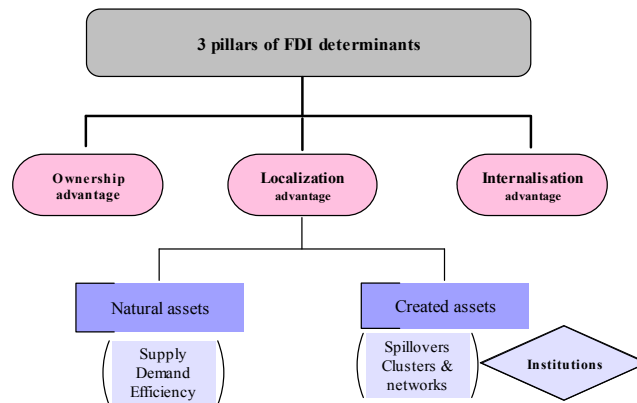
A *supply-oriented strategy* is devoted to costs optimization and, generally, generates vertical FDI. Firms seek to benefit from the productivity and quality of the production factors mainly labour (cost of unskilled labour, pool of skilled labour), the quality and reliance of physical infrastructures (telecommunication, ports, airports, and roads), the raw material endowments, the quality of social and political environment, and the level of technology (Dunning 1993; Demekas & al. 2005). With a *demand-oriented strategy* firms seek to benefit from enlarged market shares and generates horizontal FDI. The growth of demand, the market size, the consumer preferences, the per capita income, and the access to regional markets are important FDI determinants. The *efficiency-seeking aims* to create new sources of competitiveness which combines supply and demand oriented strategies linked to market access and production costs optimization. The regulatory environment, the macroeconomic stability, the ability to repatriate profit (if any) and even the presence of local or foreign competitors may also influence inward-FDI.

FDI determinants are heterogeneous and closely connected to the firm's decision to enter in vertical and/or horizontal FDI. We want to emphasize a point that is scarcely analyzed in papers: whatever the strategy adopted by a MNE, generic FDI determinants exist and deal with the easiness of doing business in a host country. Such determinants depend less from natural assets than from created assets. (Botrić and Škuflić, 2005)

In the economic literature, *created assets* as basement of the *Localization advantage* were developed by authors focusing on the spillovers effects and the networking impact of FDI agglomeration (Barell & Pain, 1999; Campos & Kinoshita 2003). In transitional countries, FDI clusters and networking may be

explained more by the lack of local infrastructures, by the weakness of the local subcontractors and even by unfavourable business environment than by positive externalities. This points out, that institutions are a strong part of the *Localization advantage* by regulating the markets and also delivering efficient public services. This idea has been recently developed in the empirical literature (Bevan & al., 2004; Narula & Dunning, 2000; Pournarakis & Varsakelis, 2004; Sehti & al. 2002) but we need to know more formally which institutions are relevant to attract foreign investors.

**Figure 1: The FDI determinants**



## 2. The institutional pattern

According to North (1990), institutions are important and endogenous elements of a country's economic growth. A good institutional pattern should be composed of a panel of formal institutions such as the rule of law driven by the State (McGee, 2004) and informal institutions based on social conventions



that are determined by the historical, cultural and sociological context of each country. The functional typology of formal Institutions proposed by Rodrik and Subramanian (2003), helps us to specify what a good market oriented institutional pattern could be.

The *Market creating institutions* represent the rules of law that protect property rights and make contracts fair and reliable for all actors. Such formal institutions based on a clear legislation and on an efficient and fair judicial system create incentives for investment and private sector development. The three next institutions contribute to the emergence of a social consensus about risks, burden and prosperity sharing in a context of a market-oriented economy. The *Market regulating institutions* help to regulate market externalities, imperfect and asymmetric information or scales economies in sectors like transportation, telecommunication or environment. The *Market stabilizing institutions* reduce macroeconomic instabilities (inflation, currency rate, balanced budget, fiscal rules) and prevent major political crisis. Finally, the *Market legitimizing institutions* support social protection and manage social conflicts. It can be an insurance system or a welfare system that protects *a minima* people from a social dropping out.

The institutional pattern is an important part of the host country's localization advantage. Stable, flexible and adaptable institutions contribute to build an endogenous attractiveness. Our purpose now is to give more content to the link "Institutions and FDI determinants" by developing the concept of *institution-based attractiveness*.

### **3. The institution-based attractiveness**

Transition created an '*institutional vacuum*' (Grogan and Moers, 2001: 327). Regarding the institutional pattern, two categories of institutions could be

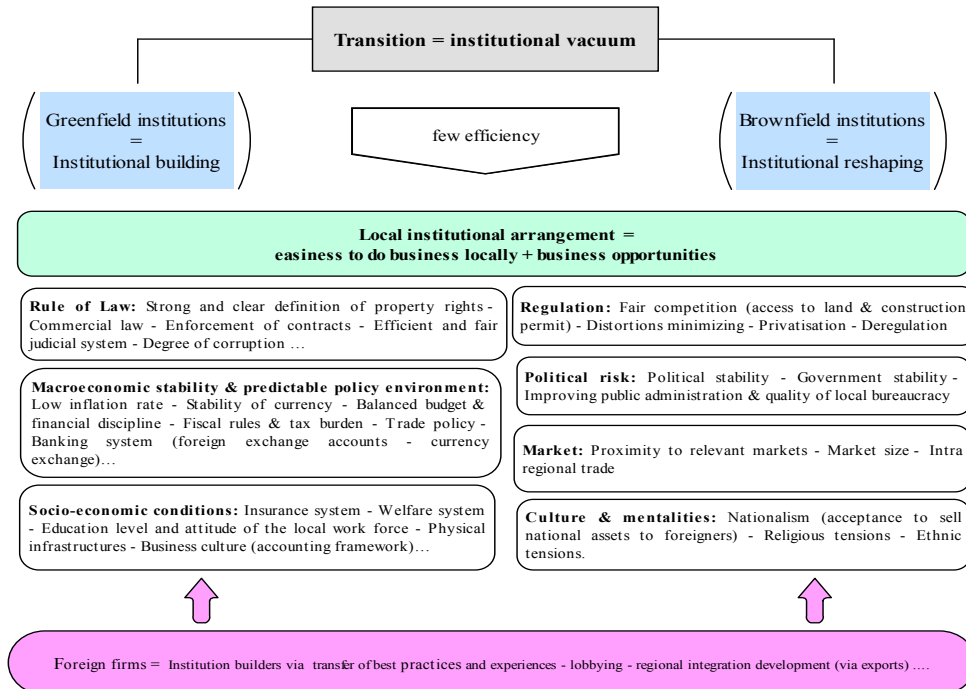
observed: the Greenfield Institutions and the Brownfield ones. Greenfield Institutions did not exist under the communist era and needed to be created and introduced while Brownfield Institutions needed to be adapted and reshaped to fit the market economy. Local reluctances could appear among individuals unwilling to get rid of their former but outdated practices and/or unable to adopt new practices. Because institutions are a local combination of social conventions and rules, historical background, cultural and geographical characteristics (Fabry & Zeghni, 2006), we may legitimately wonder whether or not institutions are prerequisite for FDI. In what extend could FDI contribute to accelerate the Institutional changes and be Institutions builders (Hewko 2002)?

The neo-institutional theoretical framework asserts that safe and reliable institutions are prerequisites for inward-FDI (Bevan & Estrin, 2004; Gray & Jarosz, 1995; Salacuse, 2000; Seidman, Seidman & Walde, 1999). We stress that in the transition context, institutions may not be considered as preconditions to FDI because they are not efficient enough to be effective. Besides, the institutional pattern should be adapted to social needs and, as Hewko (2002) mentioned, FDI may be ‘institutions builder’ by suggesting institutional adaptations and by transferring some best practices. Host countries and foreign investors interact in the transition context to build progressively a suitable institutional arrangement. That is the reason why we introduce the concept of *institution-based attractiveness*.

We call *attractiveness* the host country’s struggle to attract inward-FDI. Attractiveness is a result but also a dynamic process, which reflects both the ability of the host country to build and manage its attractiveness and the multinational firms involvement in that country. This involvement is mainly due to real business opportunities and the foreign investors’ perception of the

host country business environment (risk aversion). In short the foreign investor's involvement depends on the local opportunities and on the easiness of doing business locally.

**Figure 2: The host country institution-based attractiveness**



The *institution-based attractiveness* reflects the institution set that a country may develop at a certain period in order to attract FDI. As Rodrik (2004) argues, different stages of economic development imply different “institutional arrangements”. A catching up process may involve some originality in an institutional pattern. Foreign investors’ involvement in a country depends on the convergence of their business expectations and local institutional

arrangements. For example, contrary to Russia, a non conventional set of institutions in China has not discouraged inward-FDI (Fabry and Zeghni, 2003b).

The better the institutional arrangement in a host country, the higher inward-FDI we get. Such institutional arrangement relies essentially on the four categories of formal market institutions developed by Rodrik & Subramanian (2003). We can easily suppose that a transition country with a complete set of market institutions will host more FDI per capita than another country less endowed with institutions *ceteris paribus*. But a complete set may not be easily gathered over a short period in a transitional country characterized by institutional uncertainty. Our quest is first to separate each type of formal institution as FDI determinant and our second task is to find out which kind of institutional arrangement may have a positive impact on inward-FDI. The following hypotheses are proposed:

H1	Countries with strong market creating institutions receive more FDI per capita
H2	Countries with strong market regulating institutions receive more FDI per capita
H3	Countries with strong market stabilizing institutions receive more FDI per capita
H4	Countries with strong market legitimizing institutions receive more FDI per capita
H5	Countries with stable and transparent government system receive more FDI per capita
H6	The local institutional arrangement of each country is composed of a set of market creating institution, market regulating institutions, market stabilizing institutions and market legitimizing institutions. Countries with strong local institutional arrangement receive more FDI per capita

## II. An empirical analysis of institution-driven FDI

We test the hypothesis stated in the previous section and seek to explain inward-FDI variations among host countries. The question we address in this part is: Do institutions explain the inward FDI pattern in SEECS?

### 1. Methodology

We distinguish two categories of host countries: the *candidates to a EU membership* (Bulgaria, Croatia and Romania) that may have more efficient institutions thanks to the close fulfilment of the *Acquis communautaire criterion* and the convergence towards EU best practices, and the *non candidate countries or too recent candidate country*<sup>8</sup> (Albania, Bosnia & Herzegovina, Moldova, Serbia & Montenegro and TFYR Macedonia).

The complete panel including both categories is made of eight countries. The period concerned by our empirical analysis is 1992-2004. Traditionally, authors use cross sectional analysis (Grogan & Moers, 2001; Pournarakis & Varsakelis, 2004) or bilateral ones between home and host countries (Bevan and al., 2004) but few use pooled regression which combine time series and cross sectional data (Demekas & al. 2005). In the present empirical analysis, we use pooled regression which we consider as a relevant methodology for heterogeneous data and a short time series.

Our empirical model is built for each year (from 1992 to 2004) and for each host country. The specification of the model is as follows:

$$\text{Log FDIPC} = c_0 + \alpha_1 \log \text{GDPPC} + \alpha_2 \text{COMPET} + \alpha_3 \text{CPI} + \alpha_4 \text{EHE} + \alpha_5 \text{ER} + \alpha_6 \text{GOV}$$

---

<sup>8</sup> TFYR of Macedonia is candidate since December 2005.

The explained variable **FDIPC** is the inward foreign direct investment per capita for each year  $t$  in each host country  $c$  expressed in million of USD according to the balance of payment data. Per capita figures allow us to stress on the relative size of the host country.

Among the *independent variables*, **GDPPC** represent the real growth rate of GDP per capita for each year  $t$  in each host country  $c$ . It should be a proxy for market growth and local market potential (Chakrabarti, 2001) and will be used as a control variable to capture the demand's attraction effect on FDI which is robust according to the literature. Hence, the expected sign should be positive. Because of the small size of our sample we cannot introduce more than one control variable. We have chosen *five other independent variables* which emphasize the institutional environment effects i.e. the stage of transformation and the institutional context.

The variable **COMPET** is for country  $c$  and year  $t$  the EBRD index of competition policy. *COMPET* should measure the progress in the reform of competition policy. This is an evaluation of privatization in a quantitative perspective (share of private enterprise) but also in a qualitative one (efficiency of privatization method, the result of a privatized enterprise, and the share of foreign investor in capital).  $C$  varies from 1 (low) to 4+ (excellent). The expected sign should be positive because  $C$  reflects the efficiency of the privatization process (hypothesis H2).

The variable **CPI** is for country  $c$  and year  $t$  the Transparency International corruption perception index. *CPI* should measure the level of the institutions stabilization and the corruption. The Corruption Perceptions Index (*CPI*) ranks countries in terms of the degree to which corruption is perceived among public officials and politicians. This composite index reflects the views of businessmen and country risk analysts from around the world, including

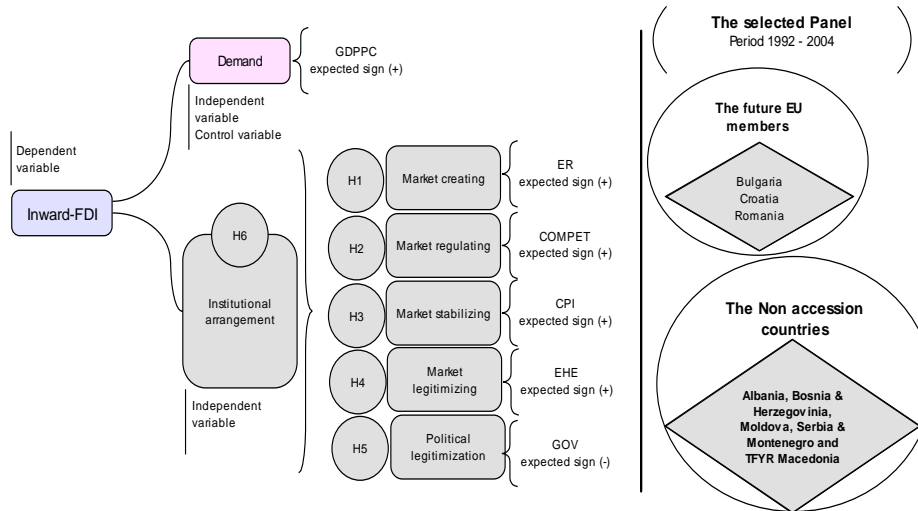
experts who are locals in the countries evaluated. This index varies from 1 (high corruption) to 10 (no corruption). The expected sign should be positive because *CPI* reflects the reduction of opacity in business rules (hypothesis H3). The variable **EHE** is for country *c* and year *t* the Expenditure on health and education as a percentage of GDP. These expenditures are those from general government, excluding those by state-owned enterprises. The expected sign should be positive because *EHE* reflects the improvements of the local social and human capital (hypothesis H4) that prevent a minima people from a social dropping out and contestation.

The variable **ER** represents the EBRD index of enterprise reform for each country *c* and year *t*. To capture progress in enterprise reform, EBRD retains, for its evaluation, criteria such as the reduction of budgetary subsidies to firms, the improvement of tax collection, the share of industry in total employment and the change in labour productivity. *ER* varies from 1 (no progress) to 4+ (excellent near standard of advanced economies) and stresses on the relationship between inward FDI in a country and the evolution of the local business environment. The expected sign should be positive because inward-FDI should be sensitive to the increase of the global efficiency of the economies (hypothesis H1).

The variable **GOV** is for country *c* and year *t* the Freedom House index. GOV is a proxy of the stability of the governmental system, and of the legislative and executive transparency. GOV synthesizes the ability of the legislative power to make law and its investigative responsibilities but also to install more decentralization of power and promote local government bodies (Hypothesis 5). GOV varies from 7 (the lowest level) to 1 (the best level). The rating follows a quarter-point scale. Minor to moderate developments typically warrant a positive or negative change of a quarter (0.25) to a half (0.50) point.

Significant developments typically warrant a positive or negative change of three-quarters (0.75) to a full (1.00) point. It is rare that the rating in any category will fluctuate by more than a full point (1.00) in a single year.

**Figure 3: The model tested**



All these five variables are proxies of the perceived quality of the institutions. These measures are subjective but close to the actor's perceptions of the local business environment climate. Figure 3 gives an overview of our empirical model.

## 2. Results of the empirical analyses

The statistical model is based on a panel data mixing temporal and country indications (pooling). The equations are tested through the generalized least square (GLS) method to avoid heteroscedasticity. For all the equations tested,



adjusted  $R^2$  and the F-test results have acceptable values, the control variable has the expected sign (+) and is statistically significant showing us that demand (GDPPC) remains a significant inward-FDI determinant. The sign of the intercept is negative and significant for all equations (except for eq.6), informing us that, if all independent variable were null, FDI would decrease. For each countries panel, all independent variables are included in equation (1), in equation (2) to (6) we introduced each different type of formal institution separately. We will focus our commentaries on some characteristic features.

Table1 concerns the complete pool composed of the eight host countries. The intercept signs are negative, except for Equation (6) and are significant. GOV and COMPET have the expected signs but are not significant in Equation (1) and are significant respectively in Equation (2) and (6). At the general institutional arrangement level (Eq.1), these two variables are no really relevant for FDI even if they have a relative importance at an individual level. EHE has a negative sign and is significant (in Equation 1 and 4) telling us that inward-FDI decrease when education and health expenses increase. It may suggest that FDI are cost-seeking oriented and do not need qualified labour. ER and CPI are significant variable. At this stage in the transition process, the reform of enterprise and the fight against corruption are very important in giving some confidence to foreign investors. Hence, non stable and transparent business environment deter inward-FDI and border them on market-seeking and cost-reducing strategies adapted to capture the various business opportunities. Nevertheless, the panel is composed of heterogeneous countries and need to be divided into future accession countries and non accession countries.

**Table 1: GLS estimations for the Complete Pool**

Complete Poll (Albania, Bulgaria, Bosnia & Herzegovina, Croatia, Moldova, Romania, Serbia & Montenegro and TFYR Macedonia) – 95 Observations						
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	-2.731845 (0.0460)**	-3.860477 (0.0000)***	-2.528736 (0.0006)***	-1.630328 (0.0461)* *	-3.356638 (0.0000)* **	2.353205 (0.0264)**
Log GDPpc	0.516858 (0.0000)***	0.745293 (0.0000)***	0.503614 (0.0000)***	0.916391 (0.0000)* **	0.516293 (0.0000)* **	0.656592 (0.0000)***
COMPET	0.055160 (0.8051)	1.168833 (0.0000)***				
CPI	0.488786 (0.0019)***		1.002749 (0.0000)***			
EHE	-0.120285 (0.0001)***			-0.159984 (0.0000)* **		
ER	1.135499 (0.0003)***				1.579525 (0.0000)* **	
GOV	0.017093 (0.9100)					-0.743828 (0.0000)***
Adjusted R <sup>2</sup>	0.807286	0.652991	0.844399	0.856403	0.592798	0.685358
F-Value	66.62808 (0.000000)	89.44319 (0.000000)	256.0541 (0.000000)	281.3040 (0.000000 )	69.42194 (0.000000 )	103.3763 (0.000000)
Method	GLS Weighted					
Probability are in bracket - P statistically significant at 1% :(***) ; at 5% (**) ; at 10% (*)*						

Table 2 deals with the accession pool composed of Bulgaria, Croatia and Romania. For all equations, the intercept has a negative sign and is significant. Nevertheless intercept has a relatively high value in Equation (1) to (4) that limits the signification of our results. Local Demand is a strong FDI determinant except in Equation (5) where this variable is non significant. COMPET becomes a relevant determinant for inward-FDI. Like in the general panel EHE is significant but has a negative sign suggesting that FDI are privatization-led. CPI stays an important problem for foreign investor. Moreover; GOV as a single determinant is significant and have the expected sign but in Equation (1) become non pertinent. In accession countries,

Institutional pattern is more transparent and FDI may be more sensitive to the local competition environment that reflects the development of the private sector.

**Table 2: GLS estimations for the Accession Pool**

Accession Pool : Bulgaria, Croatia, Romania – 39 Observations						
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	-8.367302 (0.0071)***	-9.289493 (0.0000)***	-7.598856 (0.0000)***	-10.88518 (0.0000)* **	-4.814962 (0.0098)* **	-1.720163 (0.3283)
Log GDP	0.77643 (0.0014)***	1.405297 (0.0000)***	1.041299 (0.0000)***	2.126428 (0.0000)* **	0.252341 (0.4209)	1.266143 (0.0000)***
COMPET	0.600869 (0.0586)*	1.306952 (0.0000)***				
CPI	0.500840 (0.0239)**		1.247321 (0.0000)***			
EHE	-0.115253 (0.0301)**			-0.156761 (0.0000)* **		
ER	1.813672 (0.0002)***				3.071452 (0.0000)* **	
GOV	0.186616 (0.5695)					-0.878244 (0.0000)***
Adjusted R <sup>2</sup>	0.928513	0.763565	0.835235	0.568162	0.810120	0.809761
F-Value	83.26148 (0.000000)	62.36043 (0.000000)	97.31568 (0.0000)	25.99800 (0.0000)	82.06336 (0.0000)	76.61763 (0.0000)
Method	GLS Weighted					
Probability are in bracket - P statistically significant at 1% :(***) ; at 5% (**) ; at 10% (*)						

The non accession pool mostly composed of Balkan countries presents some interesting features (Table 3). COMPET alone (Eq. 2) is significant and positively connected to FDI but in Equation (1) it is no longer significant. CPI in both cases is a relevant determinant as EHE and ER. GOV is significant in Equation (6) but not in (1) and has never the expected sign. At this stage of the transitional process, non accession countries are missing of attractiveness and are lacking of efficient institutional regulations. FDI are privatization-led and

the sectors concerned by privatization (finance, transportation, energy, telecommunication, water) are belonging to oligopolistic markets structures. Moreover, CPI is highly important and significant as ER and EHE has a negative sign. Non accession countries are seen by foreign investors as lacking of credibility. In such a difficult business environment, inward-FDI are mostly led by cost seeking strategies than by local market opportunities searches (privatization).

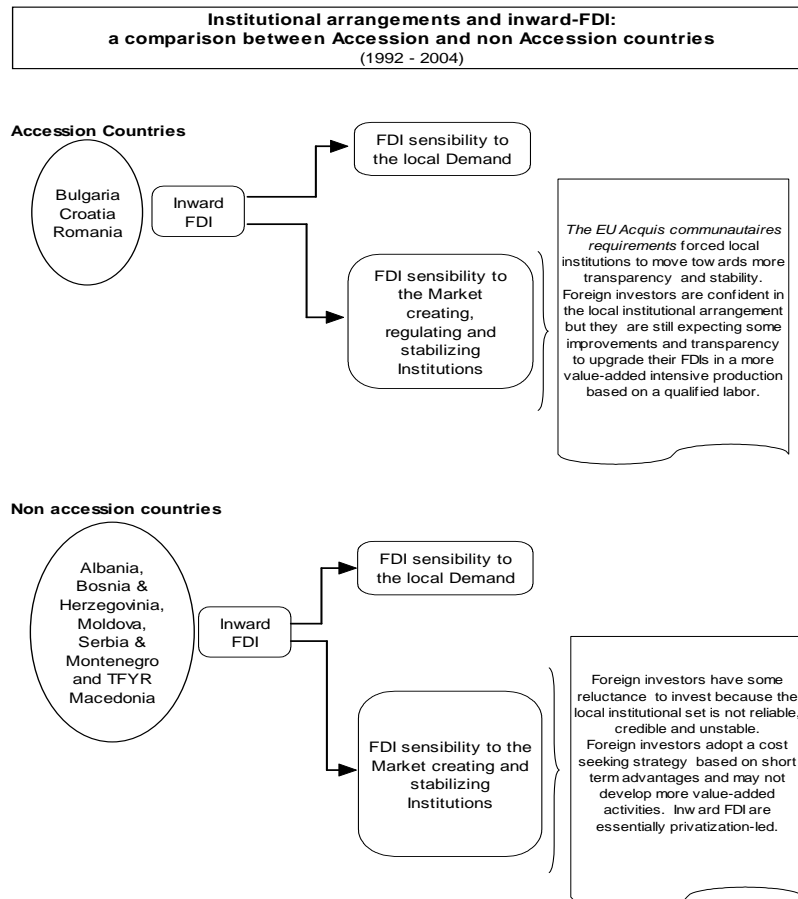
**Table 3: GLS estimations for the Non Accession Pool**

Non accession Pool (Albania, Bosnia & Herzegovina, Moldova, Serbia & Montenegro and TFYR Macedonia) – 56 observations						
	(1)	(2)	(3)	(4)	(5)	(6)
Intercept	-2.343454 (0.3545)	-2.151597 (0.0471)	-1.840049 (0.0490)	0.245537 (0.7932)	-2.485482 (0.0209)	2.783510 (0.0530)
Log GDP	0.573185 (0.0002)	0.621039 (0.0001)	0.489715 (0.0013)	0.672413 (0.0000)	0.526882 (0.0003)	0.385916 (0.0116)
COMPET	0.278306 (0.3851)	0.722925 (0.0098)				
CPI	0.348148 (0.0847)		0.818079 (0.0000)			
EHE	-0.150524 (0.0008)			-0.189680 (0.0000)		
ER	0.745354 (0.1085)				1.136389 (0.0007)	
GOV	0.087256 (0.6893)					-0.452321 (0.0024)
Adjusted R <sup>2</sup>	0.722263	0.396569	0.869702	0.817758	0.475995	0.343380
F-Value	24.83820 (0.000000)	19.07273 (0.000001)	184.5550 (0.000000)	124.3979 (0.0000)	25.98044 (0.0000)	15.38113 (0.000005)
Method	GLS Weighted					
Probability are in bracket - P statistically significant at 1% :(***) ; at 5% (**) ; at 10% (*)						

Foreign investors seem to be less influenced by institutions in accession countries than in non accession ones. We can wonder whether or not accession countries have more conventional FDI determinants, essentially demand and efficiency oriented, close to CEECs ones. This shift could emphasize the

progressive upgrading of these host countries' institutional pattern thanks to their future EU anchorage. When the host countries appear to foreign investors insecure and risky, often at the beginning of the transition process, Institutions seem to be of a major importance (Hunya 2002; Demekas & *al.*, 2005). Their pattern may attract or deter FDI.

**Figure 3: FDI determinants in SEECs**



## Conclusion

The results of our empirical test appear to confirm our expectation that FDI is sensitive to specific and local institutional arrangements. Uncertain institutional environment impedes foreign investors to do business easily and efficiently.

Inward FDI in accession countries are linked to demand and among institutions, market creating, regulating and stabilization institutions (ER, CPI, COMPET) are the most important FDI attractors. FDI are more sensitive to institutions in non candidate countries than in the future EU members. This differentiated sensibility to institutional arrangements should be explained by the EU Enlargement process and mainly the *Acquis communautaire* criterion. Before joining the EU, new members have to improve considerably their institutions in order to fulfil most of the EU requirements. Such an improvement created an institutional shift towards more stability and transparent rules. Non candidate countries are not yet concerned by these *Acquis*. Comparatively, their institutional arrangements may be seen by foreign investors as immature, unstable and less reliable.

As far as non accession countries are concerned, the role of informal institutions in attracting FDI should be explored. In these countries, the socialist legacy and its corresponding form of social capital survive in informal institutions and generate a prosperous basement for irregular practices (corruption, black markets, high paid union workers ...). Moreover, these countries have deep cultural and ethnical specifications that create conditions for a strong informal Institutional pattern which necessary influences the formal Institutions building. Except the fact that these countries are spitted up, this situation does not develop favourable conditions for change and generates a large *socialist past dependence* process. The allocation of resources devoted

to reforms and new policies setting should primarily deal with this particular situation. In our opinion, these underestimated factors explain the foreign investor's reluctance to invest once the privatization process is over. The shift from privatization-led FDI to efficiency-seeking FDI is the most important challenge these countries must face since war to avoid a banishment on the borders of Europe.

## REFERENCES

- BARDHAN P. (2005), "Institutions matter, but which ones?", *Economics of Transition, Volume 13* (3).
- BARELL R. and PAIN N. (1999), "Domestic institutions, agglomerations and FDI in Europe", *European Economic Review*, 43.
- BEVAN A. and ESTRIN S. (2004), "The determinants of FDI into European transition economies", *Journal of Comparative Economic* 32. pp 775-787.
- BEVAN A., ESTRIN S. and MEYER K. (2004), "Foreign investment location and institutional development in transition economies", *International Business Review* 13. pp 43-64.
- BOTRIĆ V. and ŠKUFLIĆ L. (2005), "Main Determinants of Foreign Direct Investment in the South East European Countries". Communication at the 2nd Euroframe Conference on Economic Policy Issues in the European Union "Trade, FDI and Relocation: Challenges for Employment and Growth in the European Union?", June 3, 2005, Vienna, Austria.
- BROADMAN H., ANDERSEN J., CLAESSENS C., RYTERMAN R., SLAVOVA S., VAGLIASINDI M., and VINCELETTE G. (2004), *Building Market Institutions in South Eastern Europe: Comparative Prospects for Investment and Private Sector Development*, The World bank, Directions in Development.
- CHAKRABARTI A., (2001), "The Determinants of Foreign Direct Investment: Sensitivity Analyses of Cross-Country Regressions", *Kyklos* 54(1), pp. 67-87.
- DALLAGO B. (2005), "Institutions and Entrepreneurship: A comparative Evaluation of South-Eastern Europe", Working Paper n°01/2005, University of Trento, School of International Studies

- DEMEKAS D., HORVÁTH B., RIBAKOVA E. & WU Y. (2005), "Foreign Direct Investment in South-eastern Europe: How (and How Much) Can Policies Help?", IMF Working papers 05/110.
- DUNNING J., (1993), *Multinational enterprises and the global economy*, Addison-Wesley, Wokingham
- EAST WEST INSTITUTE (2000), *Task Force on Economic Strategy for South Eastern Europe*, Final Report. Brussels.
- EBRD, *Transition Report* (annual)
- FABRY N. & ZEGHNI S. (2006), "How former communist countries of Europe may attract inward Foreign Direct Investment? A matter of Institutions", *Communist and Post-communist studies*, forthcoming, June.
- FABRY N. & ZEGHNI S. (2003a), "Foreign direct investment in the CEECs: How do western investors survive?" *Thunderbird International Business Review*, March.
- FABRY N. & ZEGHNI S. (2003b), "Foreign direct investment in Russia: How the investment climate matters?" *Communist and Post-Communist Studies* 35(3). 289-303
- GRAY C.W. and JAROSZ W. (1995), "Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe", *Columbia Journal of Transnational Law* 33(1), pp. 1-40.
- GRAY C., HELLMAN J. and RYTERMAN R. (2004), *Anticorruption in Transition 2, Corruption in Enterprise-State Interactions in Europe and Central Asia 1999-2002*, Washington, The World Bank.
- GROGAN L. and MOERS L. (2001), "Growth empirics with institutional measures for transition countries", *Economic System* 25. pp. 323-344.
- GWARTNEY J., HOLCOMBE R. and LAWSON R. (2004), "Economic Freedom, Institutional quality and cross-country differences in income and growth", *Cato Journal*, Vol. 24, No. 3 (Fall).
- HEWKO J. (2002), "FDI does the rule of law matter?", *Carnegie endowment for international Peace*. Rule of Law series, n°26, April.
- HUNYA G. (2002), "FDI in South-Eastern Europe in the early 2000s", The Vienna Institute for International Economic Studies (WIIW).
- KINOSHITA Y. and CAMPOS N. (2003), "Why Does FDI Go Where It Goes? New Evidence From the Transition Economies," *William Davidson Institute Working papers*
- McGEE R. (2003), "FDI in South eastern Europe", Andreas School of Business, Working Paper Series, Barry University.
- NARULA R. and DUNNING J. (2000), "Industrial development, globalization and multinational enterprises: new realities for developing countries", *Oxford Development Studies* 28(2), pp. 141-167.



NORTH D. (1990), *Institutions, institutional change and economic performance*. Cambridge University Press, New York

OECD (2001), "Foundations for Investment: progress and challenges in regulatory reform in South East Europe", Background paper, Thessalonica, 2-3 October.

OECD (2005), *Designing the Future. Making Investment Happens for Employment and Growth in South East Europe*. OECD, Paris.

PAAS T. (2003), 'Regional Integration and International Trade in the Context of EU Eastward Enlargement', HWWA Discussion Paper, 218, Hamburg Institute of International Economics.

POURNARAKIS M. and VARSAKELIS N. (2004), "Institutions, internationalization and FDI: the case of economies in transition", *Transnational Corporation* 13(2), pp. 77-94.

RODRIK D., (2004), "Globalization and Growth – Looking in the wrong places", *Journal of Policy Modelling*, 26. 513-517

RODRIK D. and SUBRAMANIAN A. (2003), The primacy of institutions, *Finance and Development* 40 (2). 31-34.

SALACUSE J. (2000), "Direct Foreign Investment and the Law in Developing Countries", *ICSID Review*, 15(2) Fall, pp. 382–400.

SCHMIEDING H. (1993), "From plan to market: on the nature on the transformation crisis", *Weltwirtschaftliches Archiv* 129, pp. 216-253.

SEHTI D., GUISENGER S., FORD D. and PHELON S. (2002), "Seeking greener postures: a theoretical and empirical investigation into the changing trend of FDI in response to institutional and strategic factors". *International Business Review* 11, pp. 685-705.

SEIDMAN A., SEIDMAN R., B. and WALDE T. (1999), "Building Sound National Frameworks for Development and Social Change", in SEIDMAN et al., (eds.), *Making Development Work: Legislative Reform for Institutional Transformation and Good Governance*, Kluwer Law International, Boston

UNCTAD (2005). *World Investment Report*. New-York

WORLD BANK (2002), *Transition: The First Ten Years*, Analysis and Lessons for Eastern Europe and the Former Soviet Union, Washington DC.

ZAKHAROV V. and KUŠIĆ S. (2003), "The Role of FDI in the EU Accession Process: The Case of the Western Balkans", Paper prepared for the ETSGs Fifth Annual Conference in Madrid, September 11-13.